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Closing Date: Thursday, November 4, 2004

FROM: Vice President and Corporate Secretary

**Public Summary: Debt Sustainability in Low-Income Countries:
Further Considerations on an Operational Framework
and Policy Implications**

Public Disclosure

1. Attached is a public summary on the joint Bank-Fund paper entitled "Debt Sustainability in Low-Income Countries: Further Consideration on an Operational Framework and Policy Implementations" that was discussed at an informal meeting of the Executive Directors on September 28, 2004 (IDA/SecM2004-0629). The IMF is also releasing a Public Information Notice on the same paper.
2. It is intended to make this document publicly available. In the absence of objection (to be communicated to the Vice President and Corporate Secretary by close of business on **November 4, 2004**), the proposal for public disclosure will be deemed approved and so recorded in the minutes of a subsequent meeting of the Executive Directors.
3. Questions on this document may be addressed to Mr. Nehru (ext. 32429) or Ms. Varma (ext. 80441).

Distribution:

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Bank Group Senior Management
Vice Presidents, Bank, IFC and MIGA
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Public Summary: “Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework and Policy Implications”

On September 28, 2004 the World Bank’s Executive Directors considered a paper entitled “Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework and Policy Implications” which was prepared jointly by the staffs of the Bank and the IMF. This paper is a follow-up to an earlier document presented to the Board in February 2004 entitled “Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications,” which provides guidance to both lenders and borrowers on new lending/borrowing decisions to help low-income countries achieve their development objectives and the Millennium Development Goals (MDGs), while maintaining sustainable levels of debt.

This follow-up paper addresses key questions raised by Bank and Fund Executive Directors in February 2004, on operational issues related to the debt sustainability framework for low-income countries. These include issues related to the robustness of the indicative debt thresholds, incorporation of domestic debt, the implementation of Debt Sustainability Analysis (DSAs), and the operational implications for the Bank, Fund and other international financial institutions and creditors.

Summary of the Paper

The proposed debt sustainability framework is distinct from the HIPC Initiative. The purpose of the HIPC Initiative is to address an existing debt overhang by providing debt relief, while the new framework is intended to provide forward-looking guidance on new borrowing and lending decisions and, relatedly, the possible need for grant financing to meet MDGs. The framework develops a country-specific approach to evaluate debt sustainability based on a two-step analysis: (i) evaluating a country’s debt burden against policy-based debt thresholds and (ii) analyzing projected debt ratios under various stress scenarios which take into account country specific factors including vulnerability to external shocks. The HIPC Initiative and the debt sustainability framework are expected to run concurrently with one another.

The paper makes the following key points on the issues raised by Executive Directors:

Debt Thresholds-The paper reiterates the importance of establishing policy-based country debt thresholds. It stresses that the threshold levels set for countries will depend largely on the country’s tolerance for debt distress. Lower thresholds signal a more conservative stance and would require higher levels of grant financing, if there is to be no change to a country’s resource flow.

Domestic Debt-On the issue of incorporating domestic debt in DSAs, the paper suggests a country-specific approach to the treatment of public sector domestic

debt. This view reflects the difficulty of establishing cross-country thresholds that incorporate domestic debt, given the lack of comparable historical data across low-income countries. The paper therefore recommends an approach to domestic debt that involves close monitoring, a careful interpretation of the benefits and risks; and a tailored response to perceived problems.

Debt Sustainability Analysis-With regard to the preparation of DSAs, the paper proposes that the Fund and Bank work collaboratively in order to present a coherent view to other creditors and country authorities. The Bank would provide inputs on key aspects of the macro framework related to its areas of expertise, and both institutions would use a common template for analysis. Each institution would be responsible for reporting to its respective Board.

Next Steps To Operationalize the Framework

The Board generally endorsed the Debt Sustainability Framework, and noted the framework should be viewed in a broader perspective of furthering development objectives. Directors highlighted its importance in helping balance the risk of future debt problems in low-income countries with the urgent need for additional financial flows to help these countries meet the MDGs.

Directors supported the use of debt-burden thresholds based on the quality of policies and institutions, and emphasized these thresholds should serve as indicative guideposts to better inform future lending and borrowing decisions rather than rigid ceilings. Some Directors expressed concern that the proposed thresholds were too high and requested that they be set more conservatively to limit the risk of future debt distress. They acknowledged that lower thresholds would require higher levels of grant financing. Directors asked the Bank and IMF staff to prepare a joint note on alternative options for thresholds and their implications for financing.

Directors emphasized the need for a full and substantive role for the Bank in DSA preparation, given its fiduciary responsibility, policy advisory role, donor coordination responsibilities, and the prospective use of DSAs in determining the allocation of grants in IDA. Directors stressed that DSAs should be prepared jointly between the Bank and Fund given the need to present a coherent view to other creditors and country authorities and noted the need to work within a clear division of labor consistent with each institution's mandate. Some Directors asked that any differences of view between the two institutions be documented in a transparent manner and brought to the respective Boards for resolution.

In general, Directors regarded domestic debt as a vital factor in determining a country's debt sustainability. They urged staff to closely monitor domestic debt and to continue to develop specific operational guidelines to address it.

The staffs of the two institutions are currently working on these issues and are planning to have a revised version of the document which they expect to present to their respective boards by the end of the year.